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In the

Supreme Court of the United States

OCTOBER TERM, 1968

ELMER E. MILLS AND LOUIS SUSMAN,
Petitioners,

vs.

THE ELECTRIC AUTOLITE COMPANY, MERGENTHALER LINOTYPE COMPANY and AMERICAN MANUFACTURING COMPANY, INC.,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioners pray that a writ of certiorari issue to the United States Court of Appeals for the Seventh Circuit to review the judgment of that Court entered on November 25, 1968, which reversed an order of the District Court for the Northern District of Illinois granting plaintiffs' motion for partial summary judgment.

OPINIONS BELOW

The opinion of the Court of Appeals for the Seventh Circuit, 403 F.2d 429, and its order are set forth in the Appendix, *infra* page 1a, and the opinion of the District Court for the Northern District of Illinois, 281 F.Supp. 826, appears at page 14a, *infra*. The District Court's Findings of Fact appearing without substantial controversy, the Conclusions of Law on which summary judgment was granted, and its earlier unreported opinion set forth beginning at page 22a of the Appendix.

JURISDICTION

The order of the Court of Appeals for the Seventh Circuit sought to be reviewed was entered on November 25, 1968. On February 21, 1969, Mr. Justice Marshall entered an order extending time to file petition for writ of certiorari until March 10, 1969. This Court has jurisdiction under 62 Stat. 928, 28 U.S.C. 1254(1). The case arises under the provisions of the Securities Exchange Act of 1934, as amended, 48 Stat. 881, 15 U.S.C. § 78a *et seq.*

QUESTIONS PRESENTED

1. Whether minority stockholders are denied any federal remedy for material misrepresentations in a proxy statement, violative of Section 14(a) of the 1934 Act, soliciting necessary votes for a merger, if the court can be satisfied that the merger terms are fair by common law standards.

2. Whether liability for material misrepresentation in a merger proxy statement violating Section 14(a) of the 1934 Act depends upon a factual finding that a critical number of votes were changed by the particular omission or misrepresentation.

3. Whether a factual finding, if relevant, that a critical number of votes were not changed by the particular omission or misrepresentation in a merger proxy statement, excusing its violation of Section 14(a) of the 1934 Act, may be predicated upon fairness of the financial terms of merger.

4. Whether all relief for material misrepresentation in a proxy statement for a merger enjoinable under Section 14(a) of the 1934 Act is barred by consummation of the merger if the court can be satisfied that the merger terms are fair by common law standards.

THE STATUTES AND RULES INVOLVED

Section 14(a) of the Securities Exchange Act of 1934 (the "1934 Act"), as amended, 15 U.S.C. § 78n(a) provides:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of any national securities exchange or otherwise to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect to any security (other than an exempted security) registered on any national securities exchange in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 14a-9(a) promulgated by the Securities and Exchange Commission pursuant to Section 14(a) of the 1934 Act, 17 C F R § 240.14a-9(a) provides:

> No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and

> in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

Section 29(b) of the 1934 Act provides "every contract made in violation of any provision of this chapter or any rule or regulation thereunder * * * shall be void * * * as regards the rights of any person who, in violation of any such provision, rule or regulation, shall have made or engaged in the performance of any such contract."

STATEMENT OF THE CASE

Plaintiffs were shareholders of The Electric Autolite Company ("Autolite"), until its merger in 1963 into Mergenthaler Linotype Company ("Mergenthaler"), which was thereupon renamed Eltra Corporation. Suing for the shareholders of Autolite as a class and derivatively on behalf of Autolite, plaintiffs alleged that the proxy statement used by the management of Autolite to solicit votes in favor of the Autolite-Mergenthaler merger was materially misleading[1] in violation of Section 14(a) of the 1934 Act and Rule 14a-9 thereunder.

Plaintiffs alleged that because votes essential to authorization of the merger were obtained through use of the unlawful proxy statement, the merger was void, and

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[1] The principal statement alleged and found to have been misleading was the advice and opinion of the Board of Directors of Autolite recommending the merger, without disclosing that the entire Board consisted of persons controlled by Mergenthaler, the adversary in the merger. App. 8a-9a.

prayed that the merger be set aside, that the assets of Autolite be returned to it, and that damages and other appropriate equitable relief be awarded. Rec. 179-180.

The District Court and the Court of Appeals both held that "mailing the proxy statement was unlawful under" Section 14(a) of the Act, because of its "omission of a material fact necessary in order to make the statements therein not misleading." App. 9a. The District Court and the Court of Appeals both found, additionally, that without the votes of the minority stockholders, obtained through the unlawful proxy solicitation, approval of the merger was not obtained. App. 10a.[2]

Having made these findings, the District Court entered "summary judgment . . . on the issue of liability alone" (Rule 56(c), Fed.R.Civ.Pro.), in the nature of a declaratory judgment for petitioners. App. 27a-28a. "Relief was left for further consideration after hearings before a special master and a report thereon." App. 10a.

The Court of Appeals held that, although the proxy statement was materially misleading, the facts did not suffice to establish the requisite causal relationship between the proxy statement and the merger, because in its view "the more exact question is whether the misleading statement and omission caused the submission of sufficient proxies." App. 11a.

This formulation of the question was thought to follow from the court's premise that liability is not established unless "the unlawful act caused some inequity or damage

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[2] "* * * the merger required favorable votes representing at least two-thirds of the Autolite shares, and * * * in order to count a two-thirds vote, one must include votes which were cast by authority of proxies obtained by the challenged solicitation". App. 10a.

which the court should relieve or redress." App. 10a. The opinion assumed that there would be nothing to relieve or redress if the trial judge were satisfied of the probability that "the merger would have received a sufficient vote even if the proxy statement had not been misleading." App. 11a. The court acknowledged that this approach smacks of the common law fraud test, "whether the injured party relied on the misrepresentation" App. 11a, n. 10. It eschewed direct resolution of that question, however, on the ground that "[r]eliance by thousands of individuals, as here, can scarcely be inquired into." *Ibid.* It resorted, instead, to indirect resolution, predicated upon a presumption that stockholders would have voted for merger, regardless of misrepresentation, if "the merger has merit and the terms were in fact fair and equitable to the minority shareholders." App. 11a. With the aid of this presumption, the court below was able to conclude: "The material offered by defendants on the merits of the terms of merger suggests that it may be possible for them to satisfy the court, by a preponderance of probabilities, that the merger would have received a sufficient vote even if the proxy statement had not been misleading in the respect found." App. 11a.

On this approach, if defendants could satisfy the court of the merit and fairness of the substantive terms, "there would be no sound basis for disruption of the merger *or other relief*", regardless of the material violation. App. 11a. (emphasis added). The Court of Appeals' express rationale was its unwillingness to "unscramble a corporate transaction merely because a violation occurred." App. 12a.

The court rejected petitioners' claim that legal injury consists of the invasion, through material misrepresentation, of the right of Autolite to continue its corporate existence, and of its shareholders as a class to preserve that status, until altered through authorization obtained in accordance with law, and that merit or fairness of the substantive terms is therefore irrelevant to the issue of liability. App 10a.

Accordingly, the court reversed and remanded the cause for further proceedings on the issue of liability (App. 12a), assessing all costs of the appeal against petitioners. App. 13a.

REASONS FOR GRANTING THE WRIT

The ruling below bars any remedy for an adjudged violation of federal law and is in conflict with decisions of this Court, and of the other federal courts, declaring that the congressional purpose must be made effective by providing a remedy when violation occurs. The principle announced by the lower court would apply, if unreversed, to a broad range of cases arising under the securities laws and under other federal regulatory statutes requiring full disclosure and fair voting. It narrows the broad remedial federal policy to the restrictive limits of the common law, making federal law superfluous. It would create almost insuperable obstacles to effective relief, and to private enforcement of federal commands on which Congress relied for effective law enforcement. Importance is measured not merely by the distortion of congressional policy, but by impairment of shareholder and public interests which the Securities Exchange Act was enacted to protect.

1. The decision below denies liability or remedy for a proven material violation of the Act, in conflict with this Court's decisions in Borak and National Securities.

This Court stated in *J. I. Case* v. *Borak,* 377 U. S. 426 (1964), "The purpose of 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation." 377 U.S. at 431. To achieve this purpose, the unanimous opinion declared that "it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose." 377 U.S. at 433. To reinforce this duty, this Court held "§27 of the Act authorizes a federal cause of action for *rescission* or *damages* to a corporate stockholder with

respect to a consummated merger which was authorized pursuant to the use of a proxy statement alleged to contain false and misleading statements violative of §14(a) of the Act." 377 U.S. at 428 (emphasis added).

These component elements, under *Borak,* complete a federal "claim upon which relief can be granted" under Rule 12(b)(6), Fed.R.Civ.Pro., without regard to the form of appropriate relief. Finding these elements established here, the District Court properly adjudged the issue of liability, and ordered further hearings on the relief to be awarded. Contravening *Borak's* enumeration of the components of the statutory cause of action, the Court of Appeals imported two additional requirements from the action for common law fraud: reliance and unfairness.

This decision transforms the broad prophylactic prohibition of the Act against seeking stockholder authorization through misrepresentation into a narrow—and superfluous —condemnation of unfair or fraudulent transactions promoted by misrepresentation. Under the ruling below, the violation of federal law becomes a matter of no consequence; whether relief may be granted turns solely upon the fairness of the merger in its substantive terms. In effect, the court below adopted the contention of petitioners Harry G. Barr, et al., in their Brief in *Borak,* p. 10, No. 402, Oct. Term 1963: "[A] deficient proxy statement followed by a beneficial merger gives rise to no cause of action, but a lawful proxy statement followed by a fraudulent merger is actionable. In short, the violation of §14(a) has no crucial bearing on the main thrust of the claim." That reading of federal law this Court rejected in *Borak,* since if it would "attach no responsibility to the use of misleading proxy statements, the whole

purpose of the section might be frustrated." 377 U.S. at 434-35.

Securities and Exchange Commission v. *National Securities, Inc.*, No. 41, this Term, decided January 27, 1969, after the Seventh Circuit's opinion, establishes that the court below misconceived the import of *J. I. Case* v. *Borak*, 377 U.S. 426. *National Securities* holds that in enforcing a requirement of the Securities Act that management "speak the truth" when soliciting authorization for a merger from shareholders, the "gravamen of the complaint [is] the misrepresentation, not the merger. The merger [becomes] relevant only insofar as it [is] necessary to attack it in order to undo the harm caused by the alleged deception." In short, the merits of the merger and its fairness are irrelevant to the violation; they bear at best upon the question of particular relief, *e.g.*, whether vindication of the federal policy can best be achieved by "a return to the *status quo ante*." Whether "unscrambling" is appropriate in any given case poses a quite different question, governed by entirely different considerations, than the question whether material misrepresentation is a remediable violation.

The *Borak* decision itself makes the point. There the contention that "the merger can be dissolved only if [the merger] was fraudulent or non-beneficial * * *" was put aside with other "issues upon which the proxy material would not bear" (377 U.S. at 431), and which related only to "appropriate relief," (377 U.S., at 435), not to the sufficiency of the cause of action.

2. The decision below frustrates the congressional policy of full disclosure by reverting to common law standards of liability.

By transforming the question of the "causal relationship of the proxy material and the merger" (*Borak*, 377 U.S. at 428) into a requirement of a "causal relationship between *the deficiency in* the proxy statement and the merger" (App. 10a, emphasis added), the court below demanded more than the nexus between the number of votes necessary for authorization and the misrepresentations "calculatedly infused into the matrix" (*Laurenzano* v. *Einbender*, 264 F. Supp. 356, 361 (E.D. N.Y. 1966)) of the proxy statement used to secure them, and reintroduced by indirection elements of common law fraud which Congress eliminated in the interest of protecting investors. "Congress intended a broad remedial construction of the Act which would encompass nondisclosure of material facts," not one which turns on fraud and deceit in their technical sense including "intent to injure and actual injury • • •." *S.E.C.* v. *Capital Gains Bureau*, 375 U.S. 180, 186, 195.

The "injury" to stockholders and to the public consists of the non-disclosure "itself, with its potential for abuse, which 'operates as a fraud or deceit' within the meaning of the Act when relevant information is suppressed." *Ibid.*, at 200. In enacting a prophylactic measure against "the darkness and ignorance of commercial secrecy [which] are the conditions upon which predatory practices best thrive" (*ibid.*), Congress did not limit its thrust to transactions which, on the merits, are unfair or unworthy; it encompassed all transactions infected by their promoters with the virus of non-disclosure. Full disclosure is required not to assure fairness, but because it is

"essential to maintain public confidence in the securities industry and to preserve the economic health of the country." *Ibid.*, at 201; *J. I. Case Co.* v. *Borak*, 377 U.S. 426, at 431-32. "Section 14(a), (c) exacts candor of disclosure, not fairness of substantive terms * * *." *Laurenzano* v. *Einbender*, 264 F. Supp. 356, 361 (E.D.N.Y. 1966).

Congress having perceived and declared the injury, it is not for the courts to reevaluate its findings (*Katzenbach* v. *McClung*, 379 U.S. 294, 303-305) or to narrow remedial coverage to injuries of a different, more traditional, type.

Moreover, in the *National Securities* case this Court declared that a scheme to mislead shareholders which resulted in their losing their status as shareholders of one company and becoming shareholders in another is, despite approval of the merger by the State, a violation of federal law. Refusal of the court below to recognize petitioners' legally protected interest in remaining shareholders of Autolite unless and until authorization for merger is lawfully obtained (App. 10a), is incompatible with this Court's approach.

3. The decision below stultifies the congressional purpose by disenfranchising the stockholders and substituting a judicial appraisal of the merger's merits for their actual and informed vote.

The Seventh Circuit's presumption that minority stockholders would authorize a merger, despite material misrepresentations, if its terms "were in fact fair and equitable to them" is unsupportable in fact; more significantly, it is utterly destructive of the remedial objective Congress intended to achieve.

Direct proof of the actual effect upon the voter of a misrepresentation[3] or omission[4] in a proxy statement is unobtainable.[5] Voters are themselves unaware of which factors may have influenced their choice. This has been demonstrated repeatedly in political,[6] labor,[7] and

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[3] "To require direct proof that the votes of a critical number of shares were changed by the Hayden, Stone Report [the proxy solicitation material], and more precisely by its misleading portions, would raise insuperable obstacles to relief and nullify the legislative purpose. The present state of understanding of human mental processes does not enable us to weigh with exactitude the components of decision or to determine scientifically that any particular element was controlling. The law does not ask more than human knowledge can supply." *Union Pacific Railroad Company* v. *Chicago and North Western Ry.*, 226 F.Supp. 400, 411 (N.D. Ill. 1964).

[4] In nondisclosure cases, the abstract and supposititious question of "reliance" on unknown information means that any such requirement could be little more than a formal requirement. 3 Loss, Securities Regulation 1766 (2d ed. 1961).

[5] Mr. Justice Cardozo, speaking of proof of reliance in *DeCicco* v. *Schweizer,* 221 N.Y. 431, 438, 117 N.E. 807, 810 (1917) said: "The springs of conduct are subtle and varied. One who meddles with them must not insist upon too nice a measure of proof that the spring which he released was effective to the exclusion of all others."

[6] Campbell, Converse, Miller & Stokes, *The American Voter* (1960) 523: "The explanations offered for an electoral result are astonishingly varied; they depend typically on the slenderest evidence, and disagreements are commonplace even among knowledgeable observers." And see, *Bell* v. *Southwell,* 376 F.2d 659, 662 (5th Cir. 1967) setting aside an election tainted by racial discrimination despite plaintiff's "inability to demonstrate that the outcome would have been different."

[7] Bok, *The Regulation of Campaign Tactics in Representation Elections Under the National Labor Relations Act,* 78 Harv. L. Rev. 38 (1964) at 40, footnote 8: "• • •

corporate elections.[8] The possibility that shareholders would not have authorized a transaction "if [they] had known the facts" (*Garment Workers* v. *Labor Board*, 366 U.S. 731, 737) can never be refuted; that possibility establishes "the unlawful genesis" of their authorization. *Ibid.*

Judge Dooling defined the statutory premises correctly in *Laurenzano* v. *Einbender*, 264 F. Supp. 356, 362 (E.D. N.Y. 1966):

> "If proxies are solicited, the stockholders have a statutory right to a truthful proxy statement. Misleading proxy material impeaches the validity of the meeting, its efficacy as a meeting. A majority stockholding cannot legitimate a meeting based on misleading information by reference to its possession of votes that would suffice to end debate. The misleading proxy material deprives the meeting, and the majority stockholder, of the expressions of view and the votes that would have ensued upon truthful disclosure; it is not legally possible to decide what legal consequences flow from the informational defects in

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[7] (Continued)
very cumbersome investigations would have to be made in a large number of cases. Moreover, the testimony received would often be unreliable * * * because voters may be largely unaware of the true reasons for their ultimate decision * * *." And at 42: "In recognition of this fact, judges and administrators have agreed that actual interference with an election need not be shown to establish a violation of the law; it is enough that the conduct in question tends to have these effects," citing *Republic Aviation Corp.* v. *NLRB*, 324 U.S. 793, 798-800 (1945). Cf. *Labor Board* v. *Donnelly Garment Co.*, 330 U.S. 219, 231.

[8] Aranow and Einhorn, *Proxy Contests For Corporate Control* 510, (2d ed. 1968).

> the meeting by asserting that the meeting would have ended in the same resolutions no matter what the views or votes of the minority. *That is not necessarily the fact and it cannot be the resolving principle of law.*" 264 F.Supp. at 362. (Emphasis added.)

Having correctly rejected direct inquiry into the voters' mental processes as the measure of legality, the court below instead resorts to indirect conjecture to determine that state of mind. The stockholder's right to cast an informed vote, declared and guarded by Congress, is thus circumvented; the court casts his vote, in effect, upon a retrospective prediction of how he would have voted if he had known the facts. This after-the-fact inquiry proceeds upon a conclusive presumption that no fair offer will be declined. The stockholder's right to decide for himself, upon full disclosure, whether the merger is fair, beneficial, and meritorious, is effectively finessed. If, in the interest of effective law enforcement, inquiry into actual effect is barred,[9] *a fortiori* does that interest bar a presumption — a conclusive presumption to boot — that illegal misrepresentation is inconsequential.

Applicable here is this Court's observation in *Silver* v. *New York Stock Exchange,* 373 U.S. 341, 366, note 18, "a substantive inquiry after the fact cannot possibly succeed in accurately ascertaining retrospectively what the outcome would have been had [the material misrepresentations not been made]. The conditioning of relief for the [misrepresentation] breach on a finding that a concomitant substantive breach occurred might well, there-

[9] The court below ascribed to mere impracticality avoidance of questioning "thousands of individuals" about their response absent misrepresentation. But, as we have seen, inquiry is foreclosed for more fundamental reasons.

fore, result in an ultimate wrongful denial of recovery • • •."

Congress enacted the 1934 Act to protect "[f]air corporate suffrage" and the "free exercise of the voting rights of stockholders." *Borak,* 377 U.S. at 431. To that end, it defined, in Section 29(b), the consequences upon a corporate transaction of its promotion by material misrepresentation: the transaction is "void." That forecloses denial of relief on the theory that material misrepresentations are "harmless." In *Eastside Church of Christ* v. *National Plan, Inc.,* 391 F.2d 357, 362 (5 Cir., 1968), cert. denied, 393 U.S. 913, the Fifth Circuit rejected the contention that the right to relief against violation of the 1934 Act is conditioned upon establishment "that any harm which [plaintiffs] suffered was caused by" the violation: "it is sufficient to show merely that the prohibited transactions occurred and that [plaintiffs] were in the protected class." In conditioning relief upon proof that the authorizing votes were caused by the material misrepresentation, the decision below is in square conflict with the Fifth Circuit.

The mainspring of the error below lies in failure to appreciate that Congress' objective was to compel full and honest disclosure, not to promote corporate transactions which happen to have "merit" or be "fair" to minority stockholders. Once Congress' policy is clearly perceived, it follows that insiders "cannot accomplish by deception what they might have accomplished honestly and then be heard to say that the deception was not the cause." *Eagle* v. *Horvath,* 241 F. Supp. 341, 344 (S.D.N.Y. 1965).

Under the lower court's test, ignoring the disclosure requirement, transactions deemed by a court to be "meri-

torious" and "fair" to minority stockholders could be fraudulently promoted with impunity. The fraudulent promoter would get two bites of the apple. If his fraud is not discovered, he would enjoy the fruits of deception without hindrance. If discovered, he may yet escape liability by convincing a court that the transaction itself was meritorious and "fair and equitable to the minority shareholders." Thus, the Seventh Circuit's approach "would place a premium on concealment [of material facts] and thereby jeopardize the salutary policies of the statute." *Wolf* v. *Weinstein*, 372 U.S. 633, 654. Moreover, on that approach, the disclosure requirements of the federal securities laws add precisely nothing to the protection of shareholders; fraudulent and unfair transactions always have been actionable in state courts.

4. The decision below stifles private enforcement suits, a necessary supplement to Commission action in enforcing the Act, by raising insuperable obstacles to relief.

In *Borak* this Court observed (377 U.S. at 432):

> "Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in anti-trust treble damage litigation, the possibility of *civil damages* or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements." (Emphasis added).

This "necessary supplement" is virtually destroyed as an "effective weapon" by the holding below. As the Court of Appeals pointed out (App. 10a), petitioners own, between them, only 5/100 of 1% of the Autolite shares. They are the "little investors who need the greatest

possible protection."[10] Yet the court below would compel the smaller shareholder, even after he has established that the proxy solicitation was unlawful, to litigate the merits and fairness of the merger as a condition precedent to *any* relief. No small investor could afford to rebut the array of expert witnesses on fairness produced by the corporation, by himself engaging expert financial witnesses, causing exhaustive audits and investigations of the books and records of huge corporations, by the taking of lengthy depositions, and by financing such items as the court reporting of a protracted trial. If the time, expense and staff requirements of such an undertaking are not available to the SEC "to permit an independent examination of the facts set out in the proxy material" (*Borak*, 377 U.S. at 432-33), obviously the small investor, whose total stake may be less than such costs, is never in a position to undertake a full-dress trial to determine the fairness of a merger.

This Court recognized the danger of chilling private actions when it said in *Borak* (377 U.S. at 435):

> "• • • the hurdles that the victim might face (such as separate suits, as contemplated by *Dann* v. *Studebaker-Packard Corp., supra,* security for expense statutes, bringing in all parties for complete relief, etc.) might well prove insuperable to effective relief."

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[10] *Surowitz* v. *Hilton Hotels Corporation,* 383 U.S. 363, 371: [D]erivative suits have played a rather important role in protecting shareholders of corporations from the designing schemes and wiles of insiders who are willing to betray their company's interest in order to enrich themselves. And it is not easy to conceive of anyone more in need of protection against such schemes than little investors like Mrs. Surowitz." See also, *Tcherepnin* v. *Knight,* 389 U.S. 332.

The Court of Appeals in this case assessed against petitioners all costs of the appeal, approximately $9,000 (App. 13a-14a), on the theory that they had not yet established liability. Confronted with the prospect of such a cost bill, as a prelude to the cost of a trial on the merits and fairness of the merger, few, if any, investors could afford to undertake even the most meritorious Section 14(a) litigation.[11]

The court below implied that petitioners were at fault for not moving to enjoin the merger. App. 9a-10a. But that imputation overlooks the obstacles confronting the private litigant. Here the violation found by the courts below was not discovered until after the meeting to approve the merger had been held, when it was pleaded in an amendment to the complaint. Rec. 163, 169-71. Of necessity, delayed discovery will be common. See *J. I. Case Co.* v. *Borak*, 377 U.S. 426, at 432-33. Preliminary injunctions are also infeasible because of the requirement of obtaining an injunction bond at prohibitive cost, or of assuming the risk of damages in the event that permanent relief were ultimately denied. Enforcement through prospective suits, whether brought by the Commission[12] or by minority shareholders, falls far short of providing "such remedies

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[11] The effect of the decision below covers not only Section 14 but also Section 10(b) of the 1934 Act, which, as this Court held in *National Securities*, must be read in *pari materia*. The principles of the decision below apply to SEC enforcement actions as well as to private suits.

[12] *National Securities* exemplifies a situation likely to recur. The Commission's request for preliminary injunctive relief was denied by the District Court, erroneously as it turned out. Exigencies of time prevented review before consummation, and remitted the Commission to retrospective relief.

as are necessary to make effective the congressional purpose." *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 433. It is for this very reason that this Court found "[no] merit in the contention that * * * remedies are limited to prospective relief." 377 U.S. at 434. To withhold any remedy because the merger itself was not enjoined is to circumvent the holding of *Borak*.

5. The decision below makes ineffectual the congressional full-disclosure policy by barring any relief once a merger, later found to be fair, is consummated.

In light of the Court of Appeals' ruling that the undisputed findings would support prospective relief by way of injunction in advance of the meeting (App. 9a), its holding that there is no liability for the consummated merger rests alone upon its expressed reluctance "to unscramble a corporate transaction merely because a violation occurred." App. 12a. No question of "unscrambling", however, was properly before that court. The District Court had postponed for future hearing the question of its duty "to provide such remedies as are necessary to make effective the congressional purpose." *Borak*, 377 U.S. at 433. Petitioner's opportunity to be heard on the form of appropriate relief was foreclosed by the interlocutory appeal, under Section 1292(b) of the Judicial Code, from the District Court's ruling on the issue of liability alone.

Pre-empting this untendered issue, the Court of Appeals adds two unfounded assumptions: that dissolution is the only proper remedy for a consummated merger, and that dissolution is too harsh a remedy for the wrong. Neither assumption can survive examination.

This Court in *Borak* recognized the lower court's choice among a wide range of remedies for a merger

consummated through a violation of the congressional disclosure requirements. "Damages" and "restitution" as well as "rescission" are mentioned by this Court. 377 U.S. at 430, 433. If "unscrambling" should appear, after fair consideration, to be unwarranted, other forms of relief would be available. On the findings affirmed below, petitioners would be entitled, at minimum, to (1) a declaratory judgment that the vote authorizing the merger was illegally obtained[13] (*J. I. Case Co.* v. *Borak,* 377 U.S. 426, 427-28); (2) counsel fees and costs for exposing and establishing this violation of the rights of the corporation and of the minority shareholders and the public (*Sprague* v. *Ticonic National Bank,* 307 U.S. 161, 166-67; *Bakery and Confectionery Workers International U.* v. *Ratner,* 118 U.S. App. D.C. 269, 274, 335 F.2d 691, 696 (D.C. Cir. 1964); (3) an injunction against violations in connection with future proxy statements and transactions (*Labor Board* v. *Express Publishing Co.,* 312 U.S. 426; *Labor Board* v. *Mexia Textile Mills,* 339 U.S. 563, 567-68); (4) an accounting to determine what financial damage, if any, resulted to Autolite and its minority stockholders from the merger (Cf. *Bynum* v. *Baggett Transportation Company,* 228 F.2d 566, 573-74 (5 Cir. 1956); (5) at least nominal damages (Restatement, *Contracts,* § 328, "Nominal Damages"; Restatements, *Torts* § 907 "Nominal Damages," and, perhaps, punitive or exemplary damages. McCormick, DAMAGES, § 81, pp. 290-91. Congress charged the courts to "be alert to provide such remedies as are necessary to make effective the congressional purpose"

[13] In contrast the Court of Appeals held that the petitioners had not established liability although they had proved "that mailing the proxy statement was unlawful", (App. 9a), and thereupon reversed the District Court's declaratory judgment of liability.

(*Borak*, 377 U.S. at 433-34) in *all* cases, not to excuse violations entirely in those cases were "unscrambling" may not be required.

Nor is dissolution foreclosed from consideration as an appropriate form of relief. Far from immunizing violations and barring any remedy, as the court below thought, hypothetical substantive fairness does not even bar undoing the merger. Reserved in *Borak*, that question was answered in *National Securities*. "• • • [T]here is no reason to emasculate the securities law by forbidding remedies which may prove to be essential."

In *Eastside Church*, *supra*, 391 F.2d at 362, the Fifth Circuit, joining the Second,[14] read the "voiding provision" of Section 29(b) as clear indication that Congress intended a "harsh remedy." There is no novelty in this, for courts of equity have long taught that effective enforcement of "insider" obligations, particularly the duty of full and fair disclosure, requires harsh remedies, including upsetting transactions in and of themselves completely fair and equitable. *Commonwealth Coatings Corp.* v. *Continental Casualty Co.*, No. 14, this Term, 37 L.W. 4037; *Mosser* v. *Darrow*, 341 U.S. 267, 274-75; *Wolf* v. *Weinstein*, 372 U.S. 633.

This is not to say that substantive merit and fairness are necessarily irrelevant to the issue of restoration of the *status quo ante*. It is to say that desirability of restoration is not, and cannot conceivably be, the touchstone of violation and that injection of the "unscrambling" issue at the violation stage destroys the efficacy of the legislation.

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[14] *Goldstein* v. *Groesbeck*, 142 F.2d 422, 426 (2 Cir. 1944).

CONCLUSION

For the foregoing reasons, the Court should grant this petition for certiorari and reverse the decision below with instructions to enter an order of affirmance, with costs to appellants below.

Respectfully submitted,

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MARCH 10, 1969

APPENDIX

OPINION OF COURT OF APPEALS.

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

SEPTEMBER TERM, 1967 — APRIL SESSION, 1968

Nos. 16613, 16614

ELMER E. MILLS and LOUIS SUSMAN,

Plaintiffs-Appellees and Appellants,

v.

THE ELECTRIC AUTOLITE COMPANY; MERGENTHALER LINOTYPE COMPANY; AMERICAN MFG. CO., INC.,

Defendants-Appellants and Appellees.

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.

November 25, 1968

Before SWYGERT, FAIRCHILD and KERNER, *Circuit Judges.*

FAIRCHILD, *Circuit Judge.* This is an appeal from an interlocutory summary judgment, determining liability alone, under one of three counts of a complaint. The question of appropriate relief was reserved. The judgment was entered September 26, 1967, an opinion, and findings of fact and conclusions of law, having been filed the same day. Defendants obtained leave to appeal under 28 U.S.C. sec. 1292(b). Plaintiffs, with similar leave, cross appealed from an order entered September 28, 1967 deleting one of the conclusions of law.

The posture of the action.

Plaintiffs attacked a corporate merger whereby The Electric Autolite Company (an Ohio corporation) was to be merged with and into Mergenthaler Linotype Com-

pany. The name of the surviving corporation was changed to Eltra Corporation. The merger was approved at a stockholder's meeting of Autolite on June 27, 1963 and has been treated as effective.

Plaintiffs held stock in Autolite. They assert that this is a derivative action on behalf of Autolite, and also that it is a class action on behalf of themselves and all other minority stockholders.

Plaintiffs filed their original complaint June 26, 1963, the day before the meeting. Their amended complaint, filed February 4, 1964, set out three counts. In each they sought a declaration that the proxies solicited by management were void, orders setting aside the merger and causing the return of assets to Autolite, and an accounting to Autolite for damages. No application was made for a restraining order or temporary injunction to prevent use of the proxies or to delay consummation of the merger.

Count II predicated jurisdiction on sec. 27 of the securities exchange act of 1934.[1] It alleged that the proxy statement sent out by management violated sec. 14(a) of the 1934 act[2] and rule 14a-9, issued under the act,[3] by misrepresentation and nondisclosure; that the proxies obtained were void, and that accordingly the merger had failed to receive valid votes representing the required two-thirds of the Autolite shares.

On November 15, 1965, after a motion by plaintiffs for summary judgment as to count II, the district court filed a memorandum concluding as a matter of law the failure to disclose certain facts was a material omission.

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[1] 15 U.S.C. sec. 78aa.

[2] 15 U.S.C. sec. 78n (a).

[3] 17 C.F.R. 240. 14a-9. "(a) No solicitation subject to this regulation shall be made by means of any proxy statement, notice of meetings or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading."

The court indicated doubt as to the consequences which must flow from that conclusion. On November 29, the court filed a memorandum opinion and order concluding that there should be a reference to a master under Rule 53(b), F.R. Civ. P. On February 14, 1966, the court filed a memorandum concluding that it would be necessary for the court to determine whether there was a causal connection between the violation of the disclosure requirements and the alleged injury to the plaintiffs before a master should look into appropriate remedial action.

At the time of entering the interlocutory summary judgment appealed from, the court found again that the proxy statement was false and misleading as a result of certain statements and omissions, found that the proxy statement was a cause of the merger, and directed that the master, previously designated, should proceed.

Plaintiffs argue that our present review is limited to the finding of causation, suggesting that the district court's 1965 order or ruling finding a violation of the disclosure rule has passed beyond review. We disagree. Just as defendants could have waited until final judgment and then have attacked on appeal all intermediate orders which involve the merits and necessarily affect the final judgment, so now, upon appeal from the interlocutory judgment they may have review of all prior orders which bear the same relationship to the interlocutory judgment.

Plaintiffs also contend we can not at this time review the order of reference with respect to the determination of relief. They apparently consider that the reference was made November 29, 1965, though suspended thereafter. Although it is true that the judgment entered September 26, 1967 does not expressly direct a reference, the accompanying memorandum makes it plain that the directions given November 29, 1965 were then revived. We consider that the appropriateness of a reference is also before us.

The deficiency in the proxy statement.

Before the merger, Mergenthaler owned 54% of the shares of Autolite outstanding. 46% of the shares were held by 8,987 other shareholders. Under the terms of the merger, the shares owned by Mergenthaler would be canceled. The shares held by others would become preferred stock of Eltra (Mergenthaler), at the ratio of 1.88 shares of preferred stock for each share of Autolite stock. The preferred stock had a par value of $34.50 per share, and would be convertible into common stock of Eltra, at the shareholder's option, share for share for two years, and at less favorable rates thereafter until the end of five years.

Thus in substance, Mergenthaler was offering that if a sufficient number of the minority shareholders of Autolite would vote to approve the merger, all minority common stock interests in Autolite would be transformed into preferred stock interests in the merged companies, with the right of each shareholder, for a time, to transform his preferred stock into Eltra common.

Because Mergenthaler owned 54% of the Autolite shares, it needed the votes of an additional 13% of the shares in order to have the merger approved by a two-thirds vote. The Autolite management solicited proxies, using the proxy statement which is under attack. The merger was approved by votes representing 82% of all the shares, 28% being owned by shareholders other than Mergenthaler.

Although the proxy statement was, in form, addressed to all shareholders, it was, in realistic terms, intended for the minority shareholders. The board of directors recommended a favorable vote, giving emphasis to the recommendation by setting it in larger and bolder type. The question considered by the district court, and decided adversely to defendants as a matter of law, was whether the relationship of the members of the Autolite board to Mergenthaler (and to a third corporation, defendant American Manufacturing Company, Inc.) was sufficiently disclosed.

The key finding was as follows:

> "8. The proxy statement was false and misleading, at the time and in the light of the circumstances under which it was made, in its statement of material facts and in its omission to state material facts necessary to make the statements therein not false or misleading, in its misrepresentation of the supposed independence of the Auto-Lite board and in its failure to inform the shareholders of the interrelationships between the Auto-Lite board and the defendants Mergenthaler and American. These misleading statements and omissions were material in the sense that an average prudent investor ought to be informed of those relationships, in order to bring his own informed and independent judgment to the question of how much weight to give to the Auto-Lite board's endorsement of the merger proposal."

The proxy statement, including financial statements and appendices, was a pamphlet of 108 pages. Statements on pages 2 and 3 indicated that the Autolite board endorsed the merger.

One of these stands out in type which is blacker and larger than the surrounding text. It says: "The Board of Directors has carefully considered and approved the terms of the merger and recommends that the shareholders vote to approve the plan of merger." Elsewhere on page 2 it is said in body type, under "Reasons for Merger": "After a thorough review of all factors involved, both Boards of Directors are of the opinion that the merger would be mutually beneficial to the Constituent Corporations and their respective shareholders." On page 3, under "Basis of Merger", there appears in body type: "The Board of Directors of Electric Autolite believes the plan of merger to be fair and equitable to the shareholders of Electric Autolite; the Board of Directors of Mergenthaler believes the plan of merger to be fair and equitable to the stockholders of Mergenthaler."

Several facts pertinent to the relationship between the eleven members of the Autolite board and Mergenthaler do appear in portions of the proxy statement.

On page 23, it is said that Mergenthaler owns 54% of the outstanding shares, and reference is also made to this fact on page 2, in a statement disclosing Mergenthaler's intention to vote its shares in favor of the merger. On page 23 it appears that four of the eleven Autolite directors are directors of Mergenthaler. One of the four, Mr. Wattles, is chairman of the board of Mergenthaler and chairman of the executive committee of Autolite. Another of the four is an officer of Mergenthaler, receiving substantial remuneration, and will continue to be an officer. Two other Autolite directors are officers of Autolite, receiving substantial remuneration, and will be officers of Eltra. On page 21, it appears that the Eltra board will be expanded to include the seven Autolite directors not on the Mergenthaler board before the merger.

Page 23 also discloses that Mr. Wattles is president and a director of American and owns about one-third of American's stock. American and Wattles together own about one-third of the pre-merger Mergenthaler stock. Three other directors of Mergenthaler are also officers, directors, and shareholders of American.

Thus the proxy statement contains information which would indicate to those aware of corporate mechanism that Mergenthaler had the power to select a majority, if not all, the members of the board, may well have exercised it, and that a minority, at least, were directors of both. Although one reference to Mergenthaler's ownership of 54% of the stock appears on page 2, where the board's recommendation is stated in boldface type, this fact is not given the same emphasis as the recommendation and the other information indicating a close relationship between some of the directors and Mergenthaler appears many pages later.

Plaintiffs produced transcripts of testimony and copies of other papers in a proceeding before the SEC, brought

by American, and terminated two months before the solicitation of the proxies. American had sought and obtained an exemption from provisions of the investment company act of 1940.[4]

Testimony of Mr. Wattles tended to show that the management of American selected directors for Mergenthaler and Autolite, and that Autolite was under the control of American. A statement was submitted to the SEC, dated November 1, 1962 by Mr. Pulleyn, who is a director of all three companies, stating it had been prepared in cooperation with Mr. Wattles. A portion of it is as follows:

> "American desires to state for the record that it continues to control the operations of Mergenthaler and Electric Autolite. The nominees for directors of Mergenthaler are selected by American in consultation with the operating management of Mergenthaler and there is only one director of Mergenthaler (to wit: William J. Flather) who has not been placed on the Board by American. He continues to serve at the pleasure of American. The directors of Electric Autolite are similarly selected. At the present time the Board of Directors of Electric Autolite consists of eleven members. Of these Messrs. Davies, Hiller, Keller, McAlpin, Perkins, Pulleyn and Wattles were and are nominees of Mergenthaler. The other four directors, to wit: Falvey, Harding, Hopkins and Jones were directors prior to the interest of Mergenthaler. These four individuals are kept as directors because in view of their understanding of the affairs of Electric Autolite and their general positions in the community, it is considered in the best interests of Mergenthaler that they continue at this time as directors."

Defendants presented affidavits of every director of Autolite, and each stated that it was his best independent business judgment that the proposed merger would be

[4] 15 U.S.C. sec. 80a-1, et seq.

beneficial to all the shareholders and that no pressure had been exerted in the matter. There was no denial, however, of the facts shown by plaintiffs with respect to selection of the directors by Mergenthaler nor the claim of control of operation generally.

Defendants also presented evidentiary material tending to show that the terms of merger were fair and equitable.

But these two propositions do not demonstrate that there is an issue for trial as to the legal adequacy of the proxy statement. For even if both were established as matters of fact, they would not fully meet the point which is presented.

In a real sense, the merger was a bargain between Mergenthaler and the minority shareholders in Autolite. The Autolite board, selected by their adversary, presumed to advise the minority shareholders to approve the merger. The crucial question at this point, with respect to the policy of the 1934 act, is not whether the advice was good, but whether the minority shareholders were sufficiently alerted to the board's relationship to their adversary to be on their guard.

It is true that approval of the merger by the board was an essential step in effecting the merger. Had the proxy statement simply reported approval, without emphasis and along with the other facts, we might have a different situation. But the Autolite management was not content with a bland statement that the board had approved. The language used in a communication which was really intended for the minority shareholders implied that the board was giving disinterested advice. Statements appearing on pages 2 and 3, one of them emphasized by the use of larger and heavier type, doubtless got the attention of some shareholders who did not read pages 21 and 23.[5] We think that under the circumstances the

[5] "The language used and the position and emphasis given to each statement, . . . may be considered in determining whether there has been a fair and candid disclosure of a material fact. . . ." *Richland* v. *Crandall* (S.D.N.Y. 1967), 262 F. Supp. 538, 554.

board was not free to state its recommendation and opinion favoring the merger without giving similar emphasis to the relationship between the directors and the other party to the bargain.

Statements in *S.E.C.* v. *Capital Gains Bureau*[6] offer guidance here though decided under the investment advisers act of 1940.[7] The Supreme Court said: "The statute, in recognition of the adviser's fiduciary relationship to his clients, requires that his advice be disinterested. To insure this it empowers the courts to require disclosure of material facts. It misconceives the purpose of the statute to confine its application to 'dishonest' as opposed to 'honest' motives. . . . The high standards of business morality exacted by our laws regulating the securities industry do not permit an investment adviser to trade on the market effect of his own recommendations without fully and fairly revealing his personal interests in these recommendations to his clients." The Court cited with approval a 1936 district court holding under the '33 act[8] "that suppression of information material to an evaluation of the disinterestedness of investment advice 'operated as a deceit on purchasers.' 15 F.Supp., at 317."

We conclude, in agreement with the district court, that as a matter of law the proxy statement failed, in connection with the advice tendered by the board, adequately to bring out the relationship between the board members and Mergenthaler. This, in terms of the rule, was an omission of a material fact necessary in order to make the statements therein not misleading. It follows that mailing the proxy statement was unlawful under 15 U.S.C. sec 78n (a) (sec. 14(a)). We have no question but that, if an injunction had been timely sought in advance of the shareholders' meeting for which the proxies were solicited, corrective measures would have been appropriate.

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[6] (1963), 375 U.S. 180, 201, 84 S.Ct. 275, 11 L.Ed.2d 237.

[7] 15 U.S.C. sec. 80b-1, et seq.

[8] *Securities & Exchange Comm'n* v. *Torr* (S.D.N.Y. 1936), 15 F.Supp. 315.

The causal relationship and appropriate relief.

In this case, although the action was filed one day before the merger, the matter did not really come before the court until too late for preventive action. The court must now determine in retrospect whether the unlawful act caused some inequity or damage which the court should relieve or redress.

It is clear that the merger required favorable votes representing at least two-thirds of the Autolite shares, and that in order to count a two-thirds vote, one must include votes which were cast by authority of proxies obtained by the challenged solicitation. The district court concluded that since this is so, the proxy statement was a cause of the merger and defendants' "liability" followed as a matter of law. Relief was left for further consideration after hearings before a special master and a report thereon.

Plaintiffs held, between them, only 5/100 of 1% of the Autolite shares, and voted against the merger, as did other holders of about 4% of the shares. Nothing in the record indicates dissatisfaction with the merger on the part of any shareholders who voted for it (the holders of 28% in addition to Mergenthaler).

Plaintiffs appear to contend that Autolite had a right to a separate existence which the court must vindicate against unlawful interference, and claim their own rights to be shareholders of Autolite, unaffected by votes at a meeting where the information supplied to the electorate did not meet the standards of the 1934 act. They seem to argue that the proxies were void because of the deficiency in the proxy statement, and that the merger is void because it did not receive enough valid votes.[9]

We think however that there is an issue for trial with respect to the causal relationship between the deficiency in the proxy statement and the merger. It follows that

[9] 15 U.S.C. sec. 78cc.

summary judgment was improper with respect to this issue.

Defendants presented evidentiary material tending to show that the merger has merit and the terms were in fact fair and equitable to the minority shareholders; that before the proxy statement was issued research consultants made an independent study and reported favorably. This report was referred to in the proxy statement. Although we have concluded that this material did not raise an issue for trial as to whether there was a material omission, we think it does bear on the cause question.

Plaintiffs and the district court deem liability established because some of the required votes depended for validity on proxies secured by the unlawful proxy statement. We think the more exact question is whether the misleading statement and omission caused the submission of sufficient proxies.[10]

The material offered by defendants on the merits of the terms of merger suggests that it may be possible for them to satisfy the court, by a preponderance of probabilities, that the merger would have received a sufficient vote even if the proxy statement had not been misleading in the respect found.[11] It seems fair to place the burden of persuasion on this issue on defendants, who are responsible for the violation, but if they are able to carry the burden, there would be no sound basis for disruption of the merger or other relief. We do not consider that the policy of the '34 act requires the court

[10] In common law fraud terms, the corresponding question would be whether the injured party relied on the misrepresentation. Reliance by thousands of individuals, as here, can scarcely be inquired into. In *J. I. Case Co.* v. *Borak* (1963), 377 U.S. 426, 431, the issue is referred to as "the causal relationship of the proxy material and the merger." The complaining stockholder pleaded in that case that the merger would not have been approved "but for" the false and misleading statements in the proxy solicitation material.

[11] See *Union Pacific R. Co.* v. *Chicago and Northwestern Ry. Co.* (N.D.Ill. 1964), 226 F.Supp. 400, 411, putting the matter in terms of probability.

to unscramble a corporate transaction merely because a violation occurred.[12]

Therefore we conclude that there is an issue for trial as to the causal relationship. The interlocutory summary judgment should not have been entered, although we agree with the district court as a matter of law that in the light of the board's statements recommending and giving opinions favorable to the merger the failure to give similar emphasis to the relationship with Mergenthaler was the omission of a material fact necessary to make the laudatory statements not misleading.

The reference to a master appears to have embraced, without guidelines or restrictions by the court, the entire issue as to relief to be granted. The present order of reference will fall along with the reversal of the judgment, and it is unnecessary to do more than to note that there is doubt whether the reference of so broad an issue was justified under Rule 53(b), F.R. Civ. P.

The district court, on September 28, 1967, struck out a conclusion that the merger was void. Had this conclusion been left standing, it would have fallen along with reversal of the judgment. We affirm the September 28 order on that basis, without considering the merits of the conclusion of voidness if the judgment had been affirmed.

The judgment entered September 26, 1967 is reversed and the cause remanded for further proceedings. The order entered September 28, 1967 and appealed from by plaintiffs is affirmed.

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[12] See, however, *Laurenzano* v. *Einbender* (E.D.N.Y. 1966), 264 F.Supp. 356, 360. The test there stated for denying motion to dismiss for want of jurisdiction is that the accused proxy material "have a transactional function and not merely be randomly present in the context of the transaction with respect to which a remedy is sought." The decision acknowledges, however, that once jurisdiction is accepted, "Much must depend on the facts."

JUDGMENT OF COURT OF APPEALS.

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60604
Monday, November 25, 1968
Before
Hon. LUTHER M. SWYGERT, *Circuit Judge*
Hon. THOMAS E. FAIRCHILD, *Circuit Judge*
Hon. OTTO KERNER, *Circuit Judge*

ELMER E. MILLS and LOUIS SUSMAN,
Plaintiffs-Appellees and Appellants,

No. 16613, 16614

vs.

THE ELECTRIC AUTOLITE COMPANY, et al.,
Defendants-Appellants and Appellees.

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the judgment of the said District Court entered September 26, 1967, in this cause appealed from be, and the same is hereby, REVERSED, and that this cause be, and it is hereby REMANDED to the said District Court for further proceedings in accordance with the opinion of this Court filed this day.

It is further ordered and adjudged by this Court that the order of the said District Court entered September 28, 1967 and appealed from by plaintiffs be, and the same is hereby, AFFIRMED.

It is further ordered and adjudged by this Court that the costs in those appeals be taxed in favor of defendants, The Electric Autolite Company, et al.

AFFIDAVIT OF PRINTING COSTS.

JEROLD S. SOLOVY, being first duly sworn on oath deposes and says that he is one of the attorneys for defendants-appellants in the above captioned matter, that he participated in the preparation and filing of appellants' brief and appendix in this cause and that appellants' costs in printing said appendix were $8,846.45. The invoice from United States Law Printing Company to affiant for printing said appendix is attached as an exhibit to this affidavit.

OPINION OF DISTRICT COURT

Memorandum, Opinion and Order, dated September 26, 1967:

I am again called upon to contribute an increment to the Federal Common Law of Corporations as derived from judicial exegesis of the Securities and Exchange Acts. This cause involves Section 14 of the 1934 Act and Rule 14a-9 as affecting omissions in Proxy Statements with regard to a corporate merger. The issue before me is the existence of a causal connection of the omissions and the merger.

The case involves a derivative class action brought on behalf of minority stockholders who have challenged the merger of Electric Auto-Lite Company, herein referred to as "Auto-Lite", with Mergenthaler Linotype Company, herein referred to as "Mergenthaler", by alleging that the Proxy Statement contained certain omissions.

The complaint alleges that the Proxy Statement failed to reveal, in soliciting a two-thirds stockholders' vote for the merger, that the directors of both Mergenthaler and Auto-Lite were controlled by a third company, American Manufacturing Company. The defendants' answer failed to deny these allegations and the plaintiffs moved for summary judgment pursuant to Rule 56. I had granted the motion for summary judgment and the remaining issue

is whether there was a causal connection between the omissions in the Proxy Statement and the merger.

In the hearing which I conducted, and considering the facts as revealed from the record before me, I find that this case involves a merger between Electric Auto-Lite Company and Mergenthaler Linotype Company.

Auto-Lite, though its principal place of business is in Ohio, has plants in over a score of states, including Illinois, Indiana and Michigan. In 1963, it had approximately 29 plants throughout the United States and Canada. Auto-Lite and its subsidiaries are principally engaged in manufacturing automotive electrical equipment, light helicopters, industrial batteries and instruments. Also, through its wholly owned subsidiaries, it is engaged in leasing industrial and business equipment. In 1962, the total net sales were $180,863,539. It had engaged in a policy of constantly acquiring smaller corporations and consolidating and expanding its activities.

Mergenthaler and its subsidiaries are engaged in the production and distribution of linotype machines and parts, Linofilm systems, and other printing equipment, and in the design and manufacture of military equipment. In 1962, it had net sales of $240,092,891, and distributes its products through sales offices in Atlanta, Boston, Chicago, Dallas, Los Angeles, New York and San Francisco. Distribution outside the United States is handled by foreign subsidiaries and a worldwide network of 57 distributors with offices in 11 countries.

Eltra Corporation, the merged entity, exists as a holding company to control the two, and thus both, presumably, would be engaged in the activity of determining major policy matters relating to automobile batteries, helicopters, the leasing of industrial equipment, the leasing of business machine equipment, the manufacture, distribution and maintenance of linotype and other printing machines and equipment, and the planning, manufacturing and distribu-

tion of various types of equipment used by our armed services in the United States and throughout much of the rest of the world. The merged entity has evolved into a leviathan which consumes smaller corporate giants and has thus attained the power to substantially affect the course of the national economy.

The Supreme Court in *J. I. Case* v. *Borak,* 377 U.S. 426 (1964) had established the right of private enforcement of Section 14a, and held that such a suit may be individual or derivative. The Federal Court also is given jurisdiction to grant relief. However, Mr. Justice Clark's opinion contained the following enigmatic statement:

> It appears clear that private parties have a right under §27 to bring suit for violation of §14(a) of the Act. Indeed, this section specifically grants the appropriate District Courts jurisdiction over "all suits in equity and actions at law brought to enforce any liability or duty created" under the Act. The petitioners make no concessions, however, emphasizing that Congress made no specific reference to a private right of action in §14(a); that, in any event, the right would not extend to derivative suits and should be limited to prospective relief only. In addition, some of the petitioners argue that the merger can be dissolved only if it was fraudulent or non-beneficial, issues upon which the proxy material would not bear. *But the causal relationship of the proxy material and the merger are questions of fact to be resolved at trial, not here. We therefore do not discuss this point further.* 377 U.S. at 431, emphasis added.

No reference to this issue is made in the Seventh Circuit decision, *Borak* v. *J. I. Case,* 317 F.2d 838 (7th Cir. 1963), nor in the order of the District Court, Civil Action File No. 56 C 247 (E.D. Wisconsin, 1956). Indeed, the Plaintiff-Respondent's brief asserted that the causal connection problem was not present. *Brief of Plaintiff-Respondent,* p. 37.

The Court in *Borak* did find that a corporate merger could be attacked on the basis of a new Federal cause of action created by Section 14(a). However, while an action brought under Section 10(b)—wherein the plaintiff seeks a money judgment to restore him to his prior position—is a private action, a Section 14 action is for enforcement of the statute since there may be no monetary recompense. As a derivative suit the action asserts the right of the corporation when the corporation refuses to assert that right itself. Comment, *Private Rights and Federal Remedies: Herein of J. L. Case* v. *Borak,* 12 UCLA L. Rev., 1161-7 (1966).

The motivating consideration is the protection of investors with private enforcement providing a supplement to Commission action with enforcement in the individual as well as the corporation. *Id.* 1168. However, because *Borak* was a decision based upon pleadings, brought by a plaintiff whose ownership was contemporaneous with the wrong alleged, the Court was not faced with the task of formulating new Federal standards to govern controverted factual issues. One such fact issue is the question of causality. The question is left to the lower Federal Courts for determination.

A principal result of the *Borak* decision is that the lower Federal Courts have been given the mandate to further develop a Federal Common Law of Corporations. Since an action under Section 14 is for enforcement rather than to effectuate a private right, the Courts must be guided by overriding national policy involving considerations of the good of the economy, which may predominate over a puritanical concern for corporate honesty, as well as a concern for the protection of the investor. Since the action may be taken on behalf of the corporation, its interests may predominate over that of the individual investor. Within this context, I find that a causal connection existed in the present case between the omissions in the Proxy Statement and the merger.

Since the *Borak* decision, Federal Courts have had occasion to consider the issue of causality. However, a number of these cases involved the presence of intervening factors so that the omissions or misstatements did not affect the merger.

In *Barnett* v. *Anaconda Company,* 238 F.Supp. 766 (S.D.N.Y. 1965), the Court held that the complaint failed to assert a causal connection between the statements in the Proxy Statement and the merger. However, the approval of the merger was a foregone conclusion, since the defendant owned more than the necessary number of shares to effectuate the merger. The Court reasoned that the merger would have been effectuated without the misleading statements. The decision, however, has been criticized in a law review note, which observes that the plaintiff was seeking not only rescission, but also damages suffered from the denial of his right to receive full value for his shares. This right is particularly in need for protection when the majority stockholder authorizing the sale is also the buyer. Delaware law, which was relevant in that case, provides that directors and majority stockholders have a fiduciary obligation to stockholders so that the defendant, as a majority stockholder would have been obliged to arrange the best possible terms in the sale and dissolution of the corporation's assets. Therefore, if the defendant's failure to provide pertinent proxy information violated Section 14, preventing the minority stockholders from protecting the true stock value, the necessary causal connection was present. Because of this misleading information, plaintiff's ability to enjoin the sale and dissolution under Delaware law, thereby protecting the value of his stock, may have been seriously impaired. Comment, 51 Iowa L. Rev. 515, 521 (1966).

In *Hoover* v. *Allen,* 231 F.Supp. 231 (S.D. N.Y. 1965) a causal connection was absent because the complaint failed to allege that the misleading statements affected the corporation adversely. Moreover, no merger was involved.

In *Eagle* v. *Horvath,* 241 F.Supp. 341 (S.D. N.Y. 1965), the Court, in denying defendants' motion for summary judgment, found that "As a matter of law . . . defendants did not control the requisite two-thirds of both classes of [certain] stock issued and outstanding at the time of the alleged violations . . ." Though the defendants had the necessary two-thirds control of the common stock, they had less than two-thirds of the preferred shares. Though they could redeem the preferred, they had not done so. The case is unclear as to what facts were presented and as to whether a summary judgment by the plaintiffs would have been granted.

No causal connection was found in *Cohen* v. *Colvin, et al.,* 266 F.Supp. 677 (1967), where the alleged benefit to the defendant occurred before the issuance of the Proxy Statement containing the false statements and omissions and the corporation was not adversely affected.

In *Laurenzano* v. *Einbender,* 264 F.Supp. 356, E.D. N.Y. (1966), Judge Dooling was troubled as to whether the doctrine of *Barnett* v. *Anaconda, supra,* be accepted and directed an immediate appeal of this question. He suggested that a causal connection might be inferred where, though the proxy statement was not a necessary or indispensable ingredient of the transaction, it was "calculatedly infused into the matrix of the transaction".

The cases appear to indicate that for a causal connection to exist the misrepresentations or omissions in the proxy statements must have a transactional function involving corporate action. *Laurenzano* v. *Einbender, supra.* The proxy statement must not be merely "randomly present" in the context of the transaction with no transactional function. *Cohen* v. *Colvin, supra; Hoover* v. *Allen, supra; Robbins* v. *Banner Industries, Inc.,* CCH Fed. Sec. L. Rep. Par. 91, 861, pp. 95, 950 (S.D. N.Y. 1966).

Where the accused proxy material is not merely "randomly present" in the context of the transaction, a causal relationship is established as intimate and direct, particu-

larly where a merger is involved. *Laurenzano* v. *Einbender, supra.* Such a direct causal relationship exists in the present case.

When false or misleading solicitation material has been used to secure stockholder approval of plans conferring pensions, bonuses or stock options to defendant directors relief appears well grounded. In those instances in which a plan would clearly have failed had the stockholders known the true facts, the plan may be terminated or rescinded with recoupment of any benefits previously conferred. Comment, *supra,* 12 UCLA L.Rev. 1150, 1181 (1966).

The cases which have considered the issue of causality have ignored the fact that an action under Section 14 is for enforcement. I had conducted a hearing to make a factual determination of the issue of causality, proceeding under the assumption that such a determination must be made as that suggested by the cases discussed above. But, after fully considering these cases and the opinion in *Borak,* along with the facts presented at the hearing, I have decided that *Borak* implies a different approach.

The *Borak* decision, by conferring upon the Federal Courts the authority to determine what type of relief may be granted for federally created rights, placed the Courts in a position where they may affect the national economy. As in *Textile Workers* v. *Lincoln Mills,* 353 U.S. 448 (1957), in the field of labor relations, the Federal Courts are now authorized to fashion a body of Federal Law for the enforcement of regulations of proxy solicitation. The Federal Courts may borrow from state law. But this development of Federal Common Law will grow on an *ad hoc* basis.

The course of development will be based upon a consideration of the needs of the national economy. In *Borak,* the plaintiff is given a right to sue derivatively under Section 14 in order to enforce the Securities and Exchange

Act for the good of the corporation and the benefit of the economy.

Causal connection must be decided within this context. Finding a causal relationship is finding *prima facie* that the circumstances surrounding the merger are not in the interests of the national economy as it relates to the industries involved in the merger, so as to justify a derivative suit to prevent an existing corporation from evolving into the type of corporate structure which should not exist. From the evidence I have before me, I am convinced that the areas of industrial activity linked by the merger are so inherently unrelated as to cause the new corporation to fall in that category of business enterprises as referred to recently by the Supreme Court as constituting a conglomerate merger, and to be inherently dangerous to a healthy economy. *United States* v. *Von's Grocery*, 384 U.S. 270 (1965); *Federal Trade Commission* v. *Proctor & Gamble Co.*, 386 U.S. 568 (1966); Rill, *Conglomerate Mergers: The Problem of Super Concentration*, 14 UCLA L. Rev. 947.

That finding being today completed and made, I am now able to proceed to complete my ruling on plaintiffs' motion for summary judgment and grant the motion and it is so ordered. The Master heretofore appointed by this Court to proceed with those matters resulting upon this order, but whose direction to proceed was held up by order of this Court pending the further determination of plaintiffs' motion for summary judgment, is now hereby directed to proceed forthwith. Quoting from my interim order of November 29, 1965, and redirecting the Master in the same language, I herein direct as follows:

(1) The Master shall act as his own counsel, but may use members and associates of his firm to assist him in his duties. He may employ such accountants and experts as he may deem necessary, but before doing so shall file an application with this Court for approval of such employment.

(2) The Master shall have the right to examine any and all corporate documents of Eltra, Mergenthaler and Auto-Lite as he may deem necessary, including, without limiting the foregoing, minute books, correspondence, proxy statements, annual reports, contracts and financial statements.

(3) The Master is authorized to hold such hearings, upon notice, as he may deem necessary, to take the testimony of the Officers and Directors of the above corporations, and to employ Court Reporters to take such testimony and transcribe the same. The Master shall file such testimony with his report thereon, with this Court.

(4) The Master shall perform such other duties as the Court shall order and direct, and shall generally perform such duties as are performed by Masters in Chancery in similar matters.

(5) In order to expedite the disposition of this litigation, the Court hereby directs the Master to make a preliminary report to this Court as promptly as possible.

The order entered today formally setting forth Findings of Fact and Granting Motion for Summary Judgment are incorporated herein by reference.

FINDINGS OF FACT AND CONCLUSIONS OF LAW OF DISTRICT COURT.

Findings of Fact:

Upon the motion of the Plaintiffs herein for the entry of Supplemental Summary Judgment in their favor upon the claim set forth in Count II of the Amended and Supplemental Complaint, the Court finds, upon consideration of the pleadings and the admissions contained therein, the affidavits and exhibits offered in support of the motion, the Responses of the Defendants to Requests to Admit submitted by the Plaintiffs, the documents produced by the Defendants in compliance with orders for the production of documents herein, the testimony and ex-

hibits herein received, and the record in this action, that there is no genuine issue as to the following material facts:

1. This is a derivative class action brought on behalf of The Electric Auto-Lite Company (Auto-Lite) and of its shareholders as a class. Auto-Lite was, at the time of the commencement of this action on June 26, 1963, a corporation incorporated under the laws of Ohio and maintained its principal place of business in that state. Plaintiff Elmer E. Mills is a citizen and resident of the state of Illinois, and was the owner of 100 shares of the common stock of Auto-Lite at the time of the transaction complained of and since May, 1961. Plaintiff Louis Susman is a citizen and resident of the state of Illinois, and was the owner of 500 shares of the common stock of Auto-Lite at the time of the transaction complained of and since April, 1957. Both plaintiffs have acted in good faith in the prosecution of this action, and fairly insure the adequate representation of the interests of Auto-Lite and of the other stockholders as a class; the action is not a collusive one brought to confer jurisdiction on the Court. The shareholders of Auto-Lite, numbering some 8,987 record owners, are so numerous as to make it impracticable to bring them all before the Court.

2. On June 26, 1963, Auto-Lite and its subsidiaries constituted a going concern, profitably engaged in the manufacture and sale of automotive electrical equipment. light helicopters, industrial batteries and instruments, with some 24 plants in the United States and Canada. On June 27, 1963, the entire outstanding stock of Auto-Lite consisted of 1,160,565 shares of common stock, par value $5, registered on the New York Stock Exchange.

3. The defendant Mergenthaler Linotype Company (Mergenthaler), on June 26, 1963, was a New York corporation principally engaged in the production and distribution of Linotype machines and other graphic arts equipment, and in the design and manufacture of military

equipment. On June 27, 1963, the entire outstanding stock of Mergenthaler consisted of approximately 2,700,688 shares of common stock, par value, $.25, and Mergenthaler owned over 50% of Auto-Lite's outstanding common stock. Since at least March, 1962, Mergenthaler had been in control of Auto-Lite by virtue of its stock ownership.

4. The defendant American Manufacturing Company (American), a Delaware corporation maintaining its principal place of business in New York, owned approximately one-third of the outstanding shares of Mergenthaler on June 26, 1963. Since at least March, 1962, American had been in control of Mergenthaler by virtue of its stock ownership.

5. The president of American, Mr. Gurdon Wattles, owned approximately 34.13% of American's voting stock, and was both a director and chairman of the board of Mergenthaler and a director and chairman of the executive committee of Auto-Lite.

6. Under date of May 29, 1963, Mergenthaler caused Auto-Lite to send to Auto-Lite shareholders, through the United States mails, a notice and proxy statement pertaining to a special meeting to be held on June 27, 1963, in Toledo, Ohio, to consider the merger of Auto-Lite and Mergenthaler. The proxy statement recited:

> "The Board of Directors has carefully considered and approved the terms of the merger and recommends that the shareholders vote to approve the plan of merger.
>
> "After a thorough review of all factors, both Boards of Directors are of the opinion that the merger would be mutually beneficial to the constituent corporations and their respective shareholders."

7. The proxy statement does not disclose that on November 2, 1962, in order to secure exemption from the Investment Company Act of 1940, the defendants stated for the record before the Securities and Exchange Com-

mission that American "continues to control the operations of Mergenthaler and Electric Auto-Lite" with seven of the eleven directors of Auto-Lite nominated by Mergenthaler and four held over as a matter of sufferance "in the best interests" of Mergenthaler.

8. The proxy statement was false and misleading, at the time and in the light of the circumstances under which it was made, in its statement of material facts and in its omission to state material facts necessary to make the statements therein not false or misleading, in its misrepresentation of the supposed independence of the Auto-Lite board and in its failure to inform the shareholders of the interrelationships between the Auto-Lite board and the defendants Mergenthaler and American. These misleading statements and omissions were material in the sense that an average prudent investor ought to be informed of those relationships, in order to bring his own informed and independent judgment to the question of how much weight to give to the Auto-Lite board's endorsement of the merger proposal.

9. Under the terms of the merger agreement, an affirmative vote of two-thirds of the shares of Auto-Lite was required for approval of the merger. The defendants owned and controlled less than two-thirds of these shares, or slightly more than 54%, and approval of the merger required approval from the owners of 141,730 shares of those not controlled by the defendants. In response to the mailing of the proxy statement, approximately 5,490 executed proxies were received from the 8,987 shareholders, of record of Auto-Lite on May 29, 1963. At the June 27, 1963 meeting, all votes concerning the proposed merger were cast wholly by proxy, including the votes of 317,291 shares cast in favor of the agreement through proxies from shareholders other than the defendants. A total of 949,271 shares were voted in favor of the merger, and 48,450 shares were voted against it. The proxies given by independent stockholders in response to the proxy

statement were necessary and indispensable to the approval of the merger.

10. No communication was sent to the shareholders of Auto-Lite in advance of the meeting of June 27, 1963, by the defendants or any other person, which corrected the misleading statements and omissions of the proxy statement. No disclosure was made by the defendants or any other person during the meeting of June 27, 1963, which corrected the misleading statements and omissions of the proxy statement. Six shareholders not officers or directors of the defendants attended the meeting of June 27, 1963, and represented about 500 shares; all voting on the merger was by proxy. Any disclosure at the meeting would have had no substantial effect on the misleading influence of the proxy statement. The misleading proxy statement was a direct and intimate cause of the merger, and a functional and necessary element in the merger transaction.

11. Pursuant to the vote by proxies submitted by mail in response to the proxy statement, the defendants have taken purported steps to effectuate the merger, including the extinguishment of Auto-Lite's corporate existence and the diminution of the percentage of the minority shareholders' equity in the business therefore conducted by Auto-Lite.

12. Since the officers and directors of Auto-Lite and Mergenthaler, as its principal shareholder, participated in the wrongful activities, and would have been compelled to act against their interests to correct the wrong, any demand upon them to rectify the wrongs would have been futile.

Conclusions of Law:

1. The Court has jurisdiction of the subject matter of the action under Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. Sec. 78aa.

2. The plaintiffs have standing to maintain this action. *J. I. Case Co.* v. *Borak,* 377 U.S. 426 (1964).

3. The defendants have committed a violation of Section 14 of the Securities Exchange Act of 1934, and of Rule 14a-9 issued by the Securities and Exchange Commission pursuant to that Section, by issuing a proxy statement which, at the time and in the light of the circumstances under which it was made, was false and misleading in its statements of material facts and in its omission of material facts necessary to make the statements therein not false and misleading.

4. The proxy material, as a matter of law and fact, was a direct and intimate cause of the merger of Auto-Lite and Mergenthaler.

5. Under the provisions of Section 29(b) of the Securities Exchange Act of 1934, the merger effectuated through a violation of Section 14 of the Act is void.

6. Since no genuine issue of material fact exists on the question of the defendants' liability, the plaintiffs are entitled to the entry of summary judgment in their favor on the issue of liability under Count II of their Complaint, and to such relief as may appear to be appropriate and just in further proceedings to be conducted in this action.

ORDER OF DISTRICT COURT.

Order Granting Motion for Summary Judgment, dated September 26, 1967:

This cause having come on to be heard on motion of the plaintiffs for summary judgment pursuant to Rule 56 of the Federal Rules of Civil Procedure; and the Court having considered the pleadings in the action, the admissions of the defendants made in response to the plaintiffs' requests to admit, the documents produced by the defendants pursuant to order of Court entered under Rule 34, the affidavits and exhibits submitted in support

of the motion, and the testimony and exhibits presented in hearings in the action, and having considered the briefs and arguments of counsel; and the Court having heretofore entered its Findings of Fact and Conclusions of Law, setting forth facts which are not the subject of substantial controversy, and finding the plaintiffs to be entitled to judgment as a matter of law, it is hereby

ORDERED, that plaintiff's motion for summary judgment as supplemented is in all respects granted, and it is further

ORDERED, ADJUDGED and DECREED that judgment be and hereby is entered for the plaintiffs herein upon the claim set forth in Count II of the Amended and Supplemental Complaint, the defendants being liable thereunder, for such relief as may be just and appropriate as determined by further order of this Court.

AMENDMENT OF ORDER OF DISTRICT COURT.

Order of Court, dated September 28, 1967:

Oral motion of defendant, without waiver of right to object to other findings and conclusions, for an immediate expunging of Par. 5 of the Conclusions of Law entered September 26, 1967, is argued and allowed.

Enter order nunc pro tunc as of September 26, 1967 striking Par. 5 from the conclusions of law and numbering Par. 6 Par. 5.

OPINION OF DISTRICT COURT OF NOVEMBER 15, 1965.

Memorandum Opinion, dated November 15, 1965, granting Summary Judgment as to Count II of the Amended and Supplemental Complaint:

This is a derivative class action brought on behalf of minority stockholders of Electric Auto-Lite Company ("Auto-Lite") against Auto-Lite and two other corporations, Mergenthaler Linotype Company ("Mergenthaler")

and American Manufacturing Company ("American Manufacturing").

In a proxy statement issued on May 29, 1963, defendants, Auto-Lite and Mergenthaler, proposed a corporate merger. At the time of the filing of this action, Auto-Lite was an Ohio corporation and through its subsidiaries it operated a successful business principally engaged in manufacturing automotive electrical equipment, light helicopters, industrial batteries and instruments. Through its wholly owned subsidiaries, it engaged in leasing industrial and business equipment. It had approximately 29 plants throughout the United States and Canada. On June 27, 1963, the entire outstanding capital stock of Auto-Lite consisted of 1,159,265 shares of common stock, par value $5.

Mergenthaler, a New York corporation, and its subsidiaries (other than Auto-Lite) were principally engaged in the production and distribution of Linotype machines and other graphic arts equipment, and in the design and manufacture of military equipment. On June 27, 1963, the entire outstanding capital stock of Mergenthaler consisted of 2,700,638 shares of common stock, par value $0.25 and Mergenthaler owned over fifty per cent (50%) of the outstanding common shares of Auto-Lite. As determined by the Securities and Exchange Commission, for two years prior to that date, Mergenthaler had been in control of Auto-Lite by virtue of its stock ownership.

American Manufacturing, a Delaware corporation, maintaining its principal place of business in New York, owned approximately one-third of the outstanding shares of Mergenthaler on June 26, 1963. The Securities and Exchange Commission determined that American Manufacturing had been in control of Mergenthaler by virtue of its stock ownership and through Mergenthaler American Manufacturing controlled Auto-Lite.

The President of American Manufacturing, a Mr. Gurdon Wattles, owned approximately 34.13% of the voting

stock of American Manufacturing. He was also a director and Chairman of the Board of Mergenthaler and Chairman of the Executive Committee of Auto-Lite.

Mergenthaler began to acquire shares of Auto-Lite on the open market. By August, 1961, Mergenthaler had acquired approximately one-third of the outstanding shares of Auto-Lite, had taken over control of Auto-Lite, had selected a majority of Auto-Lite's directors and named the executive officers. By 1962, all eleven directors of Auto-Lite had been selected by Mergenthaler. Seven Auto-Lite directors, Davies, Garber, Hiller, Keller, McAlpin, Pulleyn and Wattles were placed on Auto-Lite's board by Mergenthaler, and the other four Auto-Lite directors, Falvey, Harding, Hopkins and Jones were holdovers from the period prior to Mergenthaler's control and retained their positions as directors. After March, 1962, Mergenthaler owned over 50% of the outstanding shares of Auto-Lite.

During the time that Mergenthaler was acquiring shares of Auto-Lite on the open market, Auto-Lite acquired at least 345,000 shares of Auto-Lite stock, bringing Auto-Lite's total purchases of its own stock to 630,050 shares (approximately one-third of all its issued and outstanding shares) at a total cost to Auto-Lite for said 630,050 shares of approximately $37,000,000 of which over $20,000,000 was expended for the shares acquired in and after July, 1961. These shares were acquired at prices substantially below the net asset value per share. The effect of the acquisition by Auto-Lite of its own shares was to increase Mergenthaler's percentage ownership of Auto-Lite stock to more than 50%.

In March, 1963, American Manufacturing obtained an order from the Securities and Exchange Commission exempting it from the provisions of the Investment Company Act of 1940. It contended before the Commission that its primary activity was not investing in securities, but rather that it was a holding company conducting the

business of its controlled companies. To prove that these were controlled companies, it was necessary for American Manufacturing to establish that it exercised a controlling influence over the management and policies of Mergenthaler and Auto-Lite. [Section 2(a)(9) of the Investment Company Act.]

Testimony and written statements described below were submitted to the Commission in those proceedings to show that all of the directors and the principal executive officers of Mergenthaler, and through it the board of Auto-Lite, were controlled by American Manufacturing. These exhibits are filed in support of plaintiffs' motion for summary judgment on Count II of the Amended and Supplemental Complaint.

1. In the matter of Century Investors, Inc., et al., Docket No. 812-1300-1, Applicant's Exhibit No. 65. Memorandum in support of application for exemption from Investment Company Act under Section 3(b)(2) thereof submitted by Simpson, Thacher and Bartlett, attorneys for American Manufacturing Company, Inc.

2. In the matter of American Manufacturing Company, Inc., Docket No. 812-1300, Exhibit No. 65(a).

   American Manufacturing Company, Inc. memorandum in support of application of American Manufacturing Company, Inc., for exemption pursuant to Section 3(b)(2) of the Investment Company Act of 1940.

3. Transcript of testimony taken before the Securities and Exchange Commission in Washington, D. C., in Docket No. 812-1300-1-2, Volume 1, consisting of testimony given July 7, 1960 and comprised of pages 1 through 130, and Volume 3 consisting of testimony given on August 2, 1961, comprised of pages 194 through 285.

The complaint charges that according to the terms of the proposed merger, the business and assets of Auto-Lite having a book value of $102 million would be acquired by Mergenthaler for about $75 million.

It is alleged that minority stockholders of Auto-Lite would suffer severe financial losses upon consummation of the proposed merger since they would give up their equity in Auto-Lite in return for a new issue of convertible preferred stock in the surviving corporation with an aggregate par value of $12.5 million less than the book value of their equity in Auto-Lite.

The complaint charges that Mergenthaler caused Auto-Lite to send to shareholders of Auto-Lite a false and misleading proxy statement in order to obtain the necessary number of proxies to satisfy the terms of the merger agreement and the Ohio Corporation Law. The proxy statement, at Page 2 thereof, provides:

> "The merger is subject . . . to the prior approval of the holders of at least two-thirds of the outstanding Common Shares of Electric Autolite at the special meeting of shareholders to which this Proxy Statement relates."

Article IX of the Agreement of Merger provides as follows:

> "CONDITIONS PRECEDENT TO AGREEMENT OF MERGER
>
> 2. The obligation of Electric Autolite under this Agreement of Merger shall be subject to the existence of the following conditions . . .
>
> (g) This Agreement of Merger shall have been approved by the affirmative vote of the holders of not less than two-thirds of the outstanding . . . Common Shares of Electric Autolite."

After the proxy solicitation, the Directors of Auto-Lite received the requisite number of votes in favor of the merger and it was consummated.

The complaint is in three counts. Count I alleges common law fraud. Count II charges a violation of Section 14(a) and Section 29(b) of the Securities Exchange Act of 1934 and Rule 14a-9 thereunder. Count III asserts that the merger is *ultra vires* under Ohio Law.

Jurisdiction over Count II is based upon the Securities Exchange Act of 1934, while as to Counts I and III, the amended complaint alleges that there is diversity of citizenship and the amount in controversy exceeds $10,000. The action is brought in equity. The plaintiffs seek to have the proxies declared void, the merger set aside, and other appropriate relief.

Pursuant to Rule 56 of the Federal Rules of Civil Procedure, plaintiffs move the Court for the entry of a summary judgment in plaintiffs favor for the relief demanded in Count II in the Amended and Supplemental Complaint on the ground that there is no genuine issue as to any material fact and that plaintiffs are entitled to judgment as a matter of law.

Plaintiffs have filed, as Exhibit 4, the Findings and Opinion of the Commission in the proceedings. The proxy statement is attached as an exhibit to plaintiffs' original complaint and it is a part of the record in these proceedings.

The controlling issue of fact raised by Count II of the Complaint and defendants' answer thereto may be stated as follows: As a matter of law, did the proxy statement disclose to the shareholders of Auto-Lite all of the material facts with respect to the control of the Board of Directors of Auto-Lite by Mergenthaler and American Manufacturing so that the shareholders could bring their own independent judgment to bear on the directors' endorsement of the merger proposal?

I find that the proxy statement does not conform to the disclosure requirements of Section 14(a) and Section 29 of the Securities Exchange Act of 1934. As stated by the Seventh Circuit in *Borak* v. *J. I. Case,* 317 F. 2d 838 (1963) at page 848:

> "The obvious purpose of Section 14(a) is the protection of the right of shareholders to a full and fair disclosure of all material facts which would affect corporate elections by proxy."

A perusal of the proxy statement establishes beyond question that it contained material omissions and partial disclosures which would mislead the shareholders of Auto-Lite.

The defendants admit that they are responsible for the proxy statement of May 29, 1963 (Answer, Count II, par. 4). They admit the authenticity of the proxy statement attached as an exhibit to the plaintiffs' original complaint (Answer, Count II, par. 6).

At Page 2 of the proxy statement, there appears the following recital:

> "The Board of Directors has carefully considered and approved the terms of the merger and recommends that the shareholders vote to approve the plan of merger.
>
> "After a thorough review of all factors involved, both Boards of Directors are of the opinion that the merger would be mutually beneficial to the Constituent Corporations and their respective shareholders."

The failure of the proxy statement to disclose, in this context, that members of the Board of Directors of Auto-Lite were nominees of Mergenthaler is a material omission.

The defendants admit that they represented that both Boards of Directors are of the opinion that the merger would be mutually beneficial to the constituent corporations and their respective shareholders. (Complaint, Count II, Par. 6); (Answer, Count II, Par. 6).

The defendants admit that the proxy statement did not disclose that on the date of November 2, 1962, in order to secure exemption from the Investment Company

Act of 1940, the defendants stated for the record before the Securities and Exchange Commission that "it (American Manufacturing) continues to control the operations of Mergenthaler and Electric Auto-Lite" with seven of the eleven directors of Auto-Lite nominated by Mergenthaler and four held over as a matter of sufferance "in the best interests" of Mergenthaler (Answer, Count II, Par. 6). The defendants further admit that (Answer, Count II, Par. 2) "as of June 27, 1963, and since March 28, 1962, Mergenthaler controlled Auto-Lite in the sense that it was able to cause to be nominated and elected a majority of Auto-Lite's Board of Directors." The defendants also admit (Answer, Count II, Par. 2) that defendant American Manufacturing controlled Mergenthaler in the same fashion. Thus, the defendants admit that at all critical dates they continued to control Auto-Lite through their control of the Auto-Lite board.

In their answer, American Manufacturing and Mergenthaler advance no affirmative defenses by way of additional facts that in any way detract from their admissions of responsibility for nondisclosure of their relationship to the Auto-Lite Board of Directors.

The parties are not in agreement on all matters. Thus, the defendants (Answer, Count II, Par. 6) deny plaintiffs' allegation that the shareholders of Auto-Lite relied on the misrepresentations and nondisclosures of the proxy statement. This denial does not raise an issue of fact crucial to the plaintiffs' motion for summary judgment, for the reason that the issue of reliance of individual shareholders is not material to the right to relief from a merger based on invalid proxies.

Section 14(a) of the Securities Exchange Act of 1934 authorizes the Commission to issue regulations governing proxies and Regulation 14a-9 provides that there shall be "No solicitation" by a proxy statement that is "false or misleading with respect to any material fact" either by positive statement or by omission. The Regulation

does not refer to any element of reliance and it conspicuously avoids any use of the common law terms of "fraud" or "deceit" that might import the element of reliance.

To attach to such auxiliary private enforcement proceedings any requirement of proof of individual reliance would be inconsistent with the function of the regulatory statute and would largely destroy the effectiveness of the private enforcement remedy. Cf. *Esten* v. *United States*, 223 F.2d 19, 22 (C.A. 5, 1955).

As the Supreme Court pointed out in the *Borak* opinion, "The injury which a stockholder suffers from corporate action pursuant to a deceptive proxy solicitation ordinarily flows from the damage done the corporation, rather than from the damage inflicted directly upon the stockholder. The damage suffered results not from the deceit practiced on him alone, but rather from the deceit practiced on the stockholders as a group . . ."

To require proof of individual reliance would be contrary to the mandate of the Seventh Circuit as expressed in the *Borak* decision. As the Court observed at page 435, "Furthermore, the hurdles that the victim might face (such as separate suits, as contemplated by *Dann* v. *Studebaker-Packard Corp.* supra . . .) might well prove insuperable to effective relief."

The defendants have filed numerous affidavits in order to establish that members of the Auto-Lite board are men of honor and "independent judgment". This assertion is also found in Defendants' Answer, Count II, Par. 2.

I find it unnecessary to consider this contention since it is irrelevant to the issue before me. What is at stake is the right of the shareholders of Auto-Lite to be informed of the interrelationship between the Auto-Lite board and the defendants Mergenthaler and American Manufacturing. With knowledge of that interrelationship, the shareholders then could have brought their own informed and independent judgment to the question of how much weight

to give to the Auto-Lite board's endorsement of a merger proposal.

The following appears in 15 Fletcher Cyclopedia Corporation (Perm. Ed., 1961), at Section 7158, Pages 257-8:

> "Mergers and consolidations, which are authorized by statute in all states, usually upon the approval of two-thirds of the shareholders, can be utilized by the majority to transform the original corporation into a new one in which the rights of the minority are diminished."

Equitable remedies are available to the minority shareholders who seek to prevent being frozen out of the corporation. In the comment in 74 Harvard Law Review (1961), the following appears under the sub-heading "Equitable Remedies" at Pages 1636 and 1640:

> "Most courts agree that the majority owes some duty to the minority shareholders, and many term it 'fiduciary' . . . .
>
> "Mergers and other structural changes are especially drastic and damaging to the interests of the minority shareholder, since they change fundamentally or even extinguish the corporate entity in which he orignally invested. Furthermore, these are *not* everyday business decisions presumptively within the discretion of the board of directors."

In *Borak* v. *J. I. Case Company,* 317 F.2d 838 (7th Cir. 1963), the Court of Appeals for the Seventh Circuit stated at Page 848:

> "Section 14(a) prohibits the solicitation of proxies of securities listed on a national exchange in violation of SEC Rules promulgated thereunder. Rule 14a-9 prohibits the use of false and misleading statements with respect to any material fact or the omission of material facts which would render any statement contained in a proxy solicitation false or misleading. 17 CFR 240. 14a-9.

"Section 27 of the Act vests exclusive jurisdiction in the United States District Courts over violation of the Act or SEC Rules and over all suits in equity or actions at law brought to enforce any liability or duty created by the Act or SEC Rules.

"The obvious purpose of Section 14(a) is the protection of the right of shareholders to a full and fair disclosure of all material facts which affect corporate elections by proxy. *Dann* v. *Studebaker-Packard Corp.*, (6 Cir., 288 F. 2d 201), at 208. See also *SEC* v. *Transamerica Corp.*, 3 Cir., 163 F. 2d 511, 518, cert. denied 332 U.S. 847. For the achievement of that purpose, the jurisdiction conferred by Section 27 must be broad enough to effectively protect that right. Thus, it is said in *Bell* v. *Hood*, 327 U.S. 678, 684, that federal courts have the power, under a general grant of jurisdiction to enforce a federal statute, to grant all of the relief which may be commensurate with the effective enforcement of the statute and the protection of rights created thereby, notwithstanding the failure of the statute to specify the remedies which may be employed.

"Indeed, Section 27 has many times been so construed in cases arising under Section 10(b), the courts holding that the jurisdictional grant includes the power to award damages and other restrospective relief . . . .

"In *Deckert* v. *Independence Shares Corp.*, 311 U.S. 282, the Court, applying the provisions of the Securities Act of 1933, which were similar to the provisions of Section 27, held that purchasers of securities sold in violation of the Act had a civil cause of action, not only against the vendor of the securities and other persons specified in Section 12(a) of the Act, but also against a third person having assets of the vendor in its possession. The court said, in part, 311 U.S. at 288: 'the power *to enforce* implies the power to make effective the right of recovery afforded by the Act. And the power to make the right of recovery effective implies the power to utilize any of the procedures or

actions normally available to the litigant according to the exigencies of the particular case * * *.'

"We think the same principle must be applied in determining the scope of federal jurisdiction for the protection of rights created by Section 14(a). We hold that the court below has jurisdiction under Section 27 to award damages or such other retrospective relief to the plaintiff as the merits of the controversy may require."

In holding that a private action could be based upon a violation of Section 14(a), the Court of Appeals followed the position favored by Professor Louis Loss in his authorative treatise. (Loss, 2 Securities Regulation (2nd Ed., 1961) Pages 943-946).

In *Borak* v. *J. I. Case,* 377 U.S. 426 (1964), the Supreme Court stated at Page 432 that "Private enforcement of the proxy rules provides a necessary supplement to Commission action." The Court further held at Page 434 that the appropriate remedy to provide the needed supplement was not to be limited to "prospective relief" but was to embrace "all necessary remedial relief."

I have determined that plaintiffs' motion for summary judgment on Count II of the amended and supplemental complaint is well founded. Material facts concerning the contents of the proxy statement are not in dispute. Omissions and partial disclosures in the proxy statement do not conform to the requirements of Rule 14(a). The usual remedy in such a case is to set aside a merger based upon invalid proxies, and the plaintiffs seek this remedy. I am, however, cognizant of the fact that this derivative action is brought in equity. Substantial questions are yet to be resolved: (1) What is the extent of financial injury to the minority stockholders of Auto-Lite? (2) Must I set aside the merger as an inevitable consequence of my finding that there has been a violation of the disclosure requirements of the Securities Act? (3) What effect will a newly contemplated merger have upon disentanglement of the Auto-Lite—Mergenthaler merger? These three ques-

tions are to be briefed by the parties simultaneously and submitted to me not later than Wednesday, November 24, 1965. I do not intend to have oral arguments at that time. However, I shall study your briefs concerning appropriate remedial action. If relief requires a disentanglement of this merger and a reinstatement of the Corporate Charter of Auto-Lite or other appropriate relief, I shall appoint an impartial third person to act as a Commissioner to facilitate remedial action.

My ruling in this matter shall be subject to revision and supplemental orders. Until such time as I have decided upon appropriate relief, this shall not be considered a final order within the meaning of Rule 54(b) of the Federal Rules of Civil Procedure.